

The Role of Trust in the Governance of Business Process Outsourcing Relationships: A Transaction Cost Economics Approach

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ABSTRACT

Purpose – Business process outsourcing (BPO) has become so prevalent that a new term, the extended enterprise, has arisen to describe this approach to structuring an organization. The purpose of this article is to integrate the information systems and the interfirm governance literatures to develop a framework for the role of trust in the governance of extended enterprises.

Design/methodology/approach – This paper uses transaction cost economics (TCE) to identify the elements and stages of business process outsourcing relationships. This paper then integrates those elements with the types of trust identified in the information systems (IS) literature to develop a framework.

Findings – TCE identifies three elements that influence the design and function of interfirm relationships: the transaction, the transaction environment and the parties (the client and the vendors). TCE also recognizes three stages in the transaction: contact, contract and control. The IS literature identifies three types of trust: trusted systems, trusted institutions, and trusted partners. We link the two literatures into a framework identifying the type of trust related to each of the TCE elements. We then use these linkages to identify the types of trust appropriate for each stage of the business process outsourcing relationship. .

Originality/Value – This paper integrates the information systems and interfirm governance literatures concerning trust in inter-organizational relationships in an effort to offer a framework for building and sustaining trust between BPO vendors and clients and to identify potential directions for future research.

Keywords trust, business process outsourcing, extended enterprise, interfirm governance,
transaction cost economics

Paper type Literature review, framework development

Recent examination of end-to-end business processes has increased attention to outsourcing some or all of an organization's non-core activities. Because outsourcing allows organizations to focus on core competencies, organizations have increasingly embraced a selective sourcing strategy of outsourcing selected administrative, supply chain or information technology (IT) processes. The emergence of business process outsourcing (BPO) introduces additional relationships between firms. Because of the close nature of many of the interactions between the vendors and the client organizations, a term that describes the relationship more accurately than 'business-to-business' is *extended enterprise*. This term is appropriate because it encompasses the notion that it is not just goods and services that flow between organizations. Information that previously was proprietary, such as demand predictions and production schedules, now flows between clients and vendors. Cooperation and coordination exists between client and vendor concerning the planning, measuring and assessing for the process. Decisions may be made jointly, or at least with cognizance and consideration of the impact on other organizations. The term extended enterprise is also appropriate because clients are still responsible for the ethics and the performance of the outsourced process and the impact on their reputation (Gomes-Casseres 2005). Mouritsen and Thrane (2006) use a similar term, *network enterprise*, to describe the orchestration mechanisms that allow the firms to take advantage of the diversity of competencies and resources in different ways.

The emergence of extended enterprises has led to the need to consider interfirm governance issues. Managerial control in extended enterprises is more complex than in a single organization. Control relations are between independent companies instead of supervisors and subordinates. In addition to cost and quality issues, risk must also be assessed. One topic that frequently arises in discussions of interfirm relationships is the role of trust and its interaction

with risk and control. The majority of the research on trust in interorganizational relationships is based on three widely-accepted bases of interpersonal trust: integrity, ability and benevolence. Another type of trust that has been examined, but that has received less attention, is institutional trust. Institutional trust is the trust in third-party mechanisms that relate to the environment which can facilitate the outsourcing process. These mechanisms include the legal and regulatory systems. A third type of trust is trusted systems. Trusted systems are secure information systems. For organizations to be willing and able to share formerly proprietary information with other organizations, they have to be assured that the systems over which that information is transmitted and the locations where it's stored are secure from unauthorized access. In this study, transaction cost economics (TCE) is used as the underlying theory for developing a framework that recognizes the role of trusted systems, trusted institutions and trusted partners in business process outsourcing.

TRANSACTION COST ECONOMICS AND BUSINESS PROCESS OUTSOURCING

Much of the recent research on the governance of interfirm relationships is based on transaction cost economics (TCE) (van der Meer-Kooistra and Vosselman 2006). For BPO, TCE is valuable because it identifies the factors that should be considered when decisions about outsourcing are made. The central purpose of TCE is to explain why some transactions or transactional relationships are better accomplished by using one institutional arrangement rather than by using other arrangements. TCE recognizes three forms of institutional arrangements (organizational forms): markets, hierarchies, and hybrids (Coase 1937, 1998, Williamson 1979, 1981, 1993, 2005). Markets are defined using the economic concept of competition, which assumes perfect information, homogeneous products, large numbers of independent clients and

free resource mobility. Hierarchies are defined as bureaucracies and are traditional vertically-integrated organizations. Hybrids include the whole array of business process outsourcing arrangements that fall outside of hierarchies, such as joint ventures, networks, supply chains and extended enterprises. TCE provides guidance about which form is appropriate.

In perfect markets, terminating an outsourcing relationship has no consequences because a new relationship can theoretically be established immediately and without cost. Transaction costs occur when markets fail to meet the requirements of perfect markets. Transaction costs include the costs incurred during the three stages of the outsourcing relationship: contact, contract, and control. Transaction costs arise from three interrelated, but separate, elements: the transaction, the environment, and the parties. TCE reasoning leads firms to choose the most suitable governance structure (form of BPO relationship), thereby saving on transaction costs.

Transactions

Characteristics of the transaction include the degree of asset specificity, the complexity of the transactional relationship, and the frequency of the transaction.

Asset Specificity

Asset specificity is the degree to which assets needed for the transactional relationship are not transferable to other activities or relationships. Assets can be transaction-specific in terms of their location, physical characteristics (including processing ability), or human capital (expertise). Assets that are classified as specific if they have higher value within the transactional relationship than for other uses. In BPO low asset specificity indicates that assets required for the process do not have to be tailored to a given transactional relationship. Both vendors and clients can easily find other partners. Higher asset specificity leads to higher interdependence between the client and the vendor, sometimes involving joint investments.

Complexity of the Transactional Relationship

In TCE, the second characteristic of the transaction is the complexity of the transactional relationship. Complexity concerns the programmability of the transaction. High programmability indicates that the organizations have sufficient knowledge and information to determine in advance how the process is to be executed and which activities are expected to result in the desired outcome. In BPO complexity also includes the visibility, connectivity and flexibility of the transaction, and the level of interoperability.

Visibility refers to the amount of the process and data an organization will make available or visible to its partners. The portion of the end-to-end process that is visible to partners is known as the external process; analogously, the portion that is not visible to partners is known as the internal process. The most simplistic visibility level is one where partners have no interaction with the other organization's internal process. The most complex visibility level would allow partners to have full visibility of the internal process. According to Hollingsworth (2004), a majority of inter-organizational process relationships lie somewhere between these two extremes, favoring the simpler end.

Once visibility is established, *connectivity* can be determined to support the access of the external process. There are four types of connectivity: hardwired, contract-based, negotiated, and spontaneous. A hardwired connection is a long term and stable connection usually denoting a long term inter-organizational relationship. A contract-based access is a strategic alliance that involves frequent connections between parties. A negotiated access does not involve a contract; instead each desired process interaction requires a temporary agreement. Spontaneous access involves a simple interface between external processes and allows parties to connect when desired.

The level of *flexibility* an organization has to change process specifications depends on their partner agreement. This agreement can vary from not being able to change the process at all without prior party agreement, to changing the process anytime as long as associated parties are notified of the change immediately, to being able to change process specifications anytime without prior notice to other parties.

Within the context of visibility, connectivity and flexibility, BPO complexity is also characterized by the *level of interoperability*. Process interoperability defines how processes will interact from a system level. There are several identified levels involved in BPO relationships. The simplest involves two process systems working together using some bridging mechanism that allows routing of operations and translations and delivery of relevant data. Slightly more complex is the sharing of an agreed common standard that allows each party to directly move and manage work between them. The level of BPO complexity increases when the interoperability level between parties includes a shared format for process definitions between their systems that includes routing decisions, user access rights and maintenance of system resources. An extreme interoperability level involves a common look a feel with all system utilities between the parties. Each level increases the BPO complexity and in extended enterprises, these issues are compounded by the number of organizations in the network.

The Frequency of the Transaction

In TCE, the third characteristic of the transaction is the frequency. The frequency of the transaction is how often the organization needs the transaction accomplished. In BPO frequency also involves the modes of interoperability. These modes operationalize various methods of effectively sharing a view of process states between parties systems. Hollingsworth (1994) identified three modes of interoperability with varying levels of capability and complexity:

chained processes, nested sub-processes, and parallel synchronized. A chained process interoperability mode involves the transfer of a single item of work between two process systems which operate independently. This mode assumes that the process instance being enacted on one system triggers the creation and enactment of a sub-process instance on a second system, and once the enactment of the sub-process has begun the first process can continue with its own process. A nested sub-process mode works much the same as a chained process except once the enactment occurs, the first process will wait for the second process to complete before continuing its own process, forming a hierarchical relationship. The parallel synchronized mode allows two processes to operate independently with required synchronization points between the processes.

The Transaction Environment

The primary characteristic of the environment is uncertainty. Difficulties can arise due to communication problems, differing cultures and diverse legal and political systems. Communication problems can be due to telecommunication systems, language abilities or time-zone differences. Cultural differences may occur when domain knowledge of the client's organization is not known to the vendor and the transfer of that knowledge is costly or impossible. Diverse legal and political systems can inhibit the flow of information because it may be restricted by privacy laws. As with complexity, problems are compounded by the number of organizations and countries that are represented in the extended enterprise.

The Parties to the Transaction

In TCE, the parties are described by two characteristics, bounded rationality and opportunism. Bounded rationality has an impact on outsourcing because it means that all contingencies concerning the transactional relationship cannot be foreseen. In BPO this means

that a full and complete contract cannot be written. Thus there is uncertainty in the relationship also. Opportunism implies that parties will exploit the relationship even to the point of misrepresentation. Williamson (1985) defines opportunism as “self-interest seeking with guile” (p. 47).

Choice of Organizational Structure

Under TCE reasoning, organizations should choose markets when the transaction has low asset specificity. For this type of governance, it is assumed that there are many vendors providing the process and that clients may move from vendor to vendor with very low transaction cost. Because of the availability of other vendors in the market, individual vendors have no motivation to behave opportunistically. For outsourcing relationships with programmable, high frequency transactions, the market governance structure is appropriate under transaction cost reasoning. This is because the process interactions are well-defined and most of the outsourcing assets are transferable.

Hierarchies, also called bureaucracies, are at the other end of the governance spectrum. They are characterized by high asset specificity and/or high uncertainty in the environment. Firms choose not to outsource processes when, for example, specific investments in human knowledge needed for process participation are very important for the quality of the output and cannot be protected by contractual rules. Potentially high opportunism by the vendor(s) can also contribute to a firm’s decision not to outsource.

Hybrid forms of governance (extended enterprises) are characterized by medium to high asset specificity, which can be protected by contractual rules. Frequency of the transaction is low to medium. The outsourcing relationship is based on contracts between the client and the vendor.

But as noted above, because of the bounded rationality of both the client and the vendor and uncertainty in the environment, the contracts are always incomplete.

Trust does not have a role in traditional TCE (Williamson 1993). Governance structures and management control systems are assumed to be the result of the purposive choices of (boundedly rational) managers (Speklé 2001). These managers attempt to calculate the risks of opportunism. To the extent that control systems do not mitigate these risks, the managers are assumed to have decided to accept those risks. According to Williamson (1993), the notion of accepting these calculated risks is more precise than the notion of trust. He suggests that the term *trust* not be used in the realm of economic transactions.

But there are numerous scholars and practitioners who do not agree (e.g., Bartélemy 2003, Bhattacharjee 2002, Das and Teng 1998, Ertel 2004, Langfield-Smith and Smith 2003, Lewis 2000, Nooteboom 1996, Pavlou 2002, Tomkins 2001, van der Meer-Kooistra and Vosselman 2000, Zaheer and Venkatraman 1995). They argue that trust is needed, and, indeed, may be necessary in interfirm relationships. Zaheer and Venkatraman (1995) observe that trust, a sociological factor, is complementary to economic factors in the governance of exchange relationships. They found that including trust in the model explains governance better than a model with traditional determinants of governance alone. Das and Teng (1998) take the view that trust and control have supplementary roles in generating confidence that partners will not behave opportunistically. van der Meer-Kooistra and Vosselman (2000) continue on the path forged by these scholars and extend the TCE framework by explicitly incorporating trust as one of the efficient solutions to control in hybrid transactions and by identifying the type of trust required during the three stages of interfirm relationships (contact, contract and control). Therefore, trust does appear to have a role in the governance of BPO relationships. Below, we integrate the types

of trust found in the IS literature with the elements of BPO found in the TCE literature to develop a framework for the role of trust in BPO.

TRUST IN BUSINESS PROCESS OUTSOURCING FRAMEWORK

The three elements (the transaction, the transaction environment and the parties) that characterize whether transactions will be carried out through markets, hierarchies, or hybrid arrangements are used here to organize previous research on trust in business process outsourcing (BPO). The research reviewed is not limited to TCE-based studies. A framework based on TCE reasoning is used because it provides an approach to organizing the literature that highlights essential aspects of BPO relationships. The three elements that characterize transactions, ie., the transaction, the transaction environment and the parties, are related to the three types of trust, trusted systems, trusted institutions, and trusted partners, respectively. Figure 1 presents an overview of the framework discussed below.

[insert FIGURE 1 about here]

van der Meer-Kooistra and Vosselman (2000) incorporated the notion of trusted partners into TCE and discussed the types of trust needed at each of the stages. Langfield-Smith and Smith (2003) further adapted the van der Meer-Kooistra and Vosselman model by discussing trust for each of the elements: the transaction, the transaction environment and the parties. Although neither van der Meer-Kooistra and Vosselman nor Langfield-Smith and Smith explicitly consider types of trust other than trust in parties, they both discuss the importance of the institutional environment. Although not discussed in the TCE literature, trust in the very systems that make the widespread existence of extended enterprises possible is included here.

Transactions and Trusted Systems

In TCE, as noted above, the characteristics of the transaction are asset specificity, complexity, and frequency. For our discussions of trust in BPO relationships, we include a characteristic of the transaction that is often discussed in the information systems literature, the security of the transaction. Although the discussions of asset specificity in TCE recognize that technology plays a role in describing transactions, the role of trust in the communication technology is not discussed. For example, Arrow (1994) drew attention to the investment character of some transaction costs, in particular the costs of gathering and generating information. He noted that transaction cost may consist of two elements, capital investment and current cost. He concluded transaction costs may decrease in the course of time due to the investment in information technology. And, in fact, over the last decade, there has been an increase in the capacity and a decrease in the price of telecommunications and web-based applications (Dicken 2003, Jones, Bowonder and Wood 2003). Nicholson, Jones, and Espenlaub (2006) use TCE reasoning to focus on reduced telecommunications transaction cost in the outsourcing of the accounting and finance function to vendors in India. But information security has not been explicitly examined in the TCE literature. The information that flows between the client and the vendors is often proprietary, sensitive and, legally, must be protected (e.g., credit card numbers). Violations of information security can be costly and the systems on which this information flows must be trusted.

The importance of trusted systems is widely recognized in the information systems literature (e.g., Carrier 2006, Campbell 2006, Cummings 2004, Iyer 2004, Mitchell 2005, Straub and Welke 1998, Watson, et al. 1997). Trusted systems are the hardware and software that allow innovative relationships to transpire and that seek to protect the parties from intentional or

unintentional negative actions and consequences. When referring to websites or portals, the term ‘online trust’ has been used to describe trusted systems. Recently, scholars and practitioners have developed a compelling list of aspects that engender trust in the system (Hosmer 2006, Burr et al. 2002, Pfleeger and Pfleeger 2003). These aspects are availability, confidentiality, accountability, and system integrity.

Availability represents the information resources (information, information processing, websites, etc.) that are accessible to legitimate parties (people, organizations and/or systems) in an appropriate timeframe. It means that ‘authorized’ parties can use information resources when and where the resources are needed. Availability becomes increasingly important with global vendors and clients. Not only must up-to-date data be accessible when current or potential clients need it, but power and networks also need to be continuously available. Denial of service, the opposite of availability, can be devastating to clients.

Confidentiality refers to the information resources that are accessible *only* to authorized parties. Confidentiality means that an organization can avoid disclosing information to people or systems not authorized to access it. Confidentiality requires protection of sensitive data in all forms (stored and printed) and over the entire life of the data, from initial input through transmission and storage up to the final disposal. Sensitive information includes the proprietary business information that is private to the organization and potentially damaging in the hands of competitors. Sensitive information also includes a whole range of data about employees and customers. This information is subject to privacy statutes and must be guarded carefully by the vendor to avoid subjecting both organizations to legal action.

Accountability means that both the client’s and the vendor’s actions upon and access to information resources can be positively identified. Accountability is the ability to identify the

person, organization or system responsible for specific access and actions and is heavily dependent upon strong identification, authentication and authorization procedures. Another important aspect of accountability in outsourcing is non-repudiation, where enough evidence is available to assure that a party cannot deny their actions. Digital signatures and private key encryption are useful non-repudiation procedures.

System integrity is the ability to restrict modification of resources to authorized parties for appropriate changes. System integrity is the broadest and most difficult to define aspect of trusted systems because it means different things to different people in different contexts. Integrity of data means that the information is obtained from a reliable source, the transaction generating the data is an authorized transaction, the data is securely stored so that it cannot be corrupted without detection, and the data is transmitted securely so that the data or message delivered is the same as the data sent. Integrity of an application means that the program or server is unmodified or is modified only in acceptable ways by authorized people or programs using approved procedures. Integrity of an application also means that it performs the business logic operations in a consistent and predictable manner. For example, a transaction that is not successfully completed should have prescribed procedures for removing all aspects of the transaction and notification of appropriate parties. Integrity of middleware and networks incorporates the same aspects of security as applications, but because middleware and networks are subject to more external attacks, they need increased monitoring and auditing.

It is important that these aspects of trusted systems are integrated and balanced properly to protect the BPO relationship and ensure interoperability of the outsourced process (Mitchell 2005, Pfleeger and Pfleeger 2003, Watson, et al. 1997). Confidentiality, accountability and integrity are complementary and have overlapping control procedures. For example, access,

authentication and authorization controls are useful for all three. Each of these aspects places limits on the utilization of information resources in order to protect those resources. Availability may seem to conflict with the other aspects but the purpose of the limitations is to ensure that the resources are indeed available when needed.

Transaction Environment and Trusted Institutions

Transaction cost reasoning stresses the significance of the transaction environment. Legal rules and policies of local, national and international governments, regulations set up by national organizations (e.g., trade unions) all influence the options that clients and vendors have. Trust in these commerce control mechanisms is trust in the institutional controls that seek to provide assurance against and remedies for some types of harmful actions and negative consequences (Zucker 1986). Institutional trust is the belief that proper, accepted, official and unofficial, formal and informal structures are in place to enable companies to anticipate situation normality and a successful outsourcing relationship. van der Meer-Kooistra and Vosselman (2000) point out that outsourcing requires this macro level support of legal and institutional frameworks.

Trusted institutions are important because of the risks in BPO relationships. Beasley, Bradford and Pagach (2004) identify seven risks involved in outsourcing: strategic market risks, operations risks, finance risks, human capital risks, IT risks, legal risks and reputation risks. Mitigation of these risks and/or resolution of associated conflicts depend in some part on the transaction environment.

Much of the research on institutional trust has been in online marketplaces (e.g., Gefen, Karahanna and Straub 2003, Ratnasingam, Gefen and Pavlou 2005, Pavlou 2002). In an online marketplace for consumers, Pavlou and Gefen (2004) found that third-party institutional

mechanisms that facilitate transaction success engender trust, not only in a few reputable sellers, but in the entire community of sellers. Pavlou (2002) came to an analogous conclusion for online B2B marketplaces. These are important findings for BPO because one aspect of trusted institutions is the assumption of situational normality.

Situation normality implies that the regular business environment expectations and behavior also prevail in BPO. This aspect of trusted institutions is critical because outsourcing can bring together a number of parties with no interpersonal familiarity or cultural similarity. Vendors and clients need to be able to rely on the fact that BPO partners are bound by assurances, regulations and contracts. McKnight et al. (1998) point out that trust in situation normality relies in part on these commerce control mechanisms and in part on trusted partners that will fulfill their obligations in a predictable manner.

However, the characteristics of a normal situation in one location may not be the same set of characteristics in another situation. One reason for the difference is the legal and regulatory environment. BPO is highly dependent on contracts and the legal remedies available for violations. Contracts and service level agreements can identify the expectations and obligations of both (all) parties. Legal bonds provide incentives for organizations to refrain from opportunistic activities if the potential legal costs are higher than the gains from those activities. But because contracts cannot identify unforeseen situations, they cannot provide guarantees of cooperative behavior from outsourcing partners nor can they provide adequate insurance against all losses. Nicholson, Jones and Espenlaub (2006) note that BPO contracts must be written with specific regard toward the legal restrictions that may apply. For example, the European Union Data Protection Directive of 1995 restricts what data can be transferred or stored in countries

without equivalent rules and enforcement procedures. And countries like India have no such regulations.

Parties to the Transaction and Trusted Partners

The social context in which transactions are embedded influences the relationship and the parties' behavior. Researchers such as Chiles and McMakin (1996), Nooteboom, Berger and Noorderhave (1997) and Zaheer and Venkatraman (1995) demonstrate that trust plays a role in cooperation and that coercion, incentives and trust are relevant aspects of governance. Carr (2004) observes that outsourcing poses a central strategic challenge: organizations must defend their competitive advantages (many of which were built on the proprietary control of or distinctive use of information) while allowing information to flow between them and their outsourcing vendors. He points out that new technologies will never conquer cutthroat competition (opportunism). van der Meer-Kooistra and Vosselman (2000) note that the presence of trust between cooperating parties is especially important in situations characterized by uncertainty and strong dependencies due to specific investments.

Trusted outsourcing partners exhibit the moral and ethical characteristics that a trusted person would exhibit – they are honest, caring and able. While these elements of trust were originally intended to describe interpersonal dyadic trust, substantial evidence now exists that they are useful concepts in describing inter-organizational trust. Several researchers have validated these elements of trust and have labeled them: organizational integrity, benevolence and ability.

Organizational integrity means outsourcing partners are forthright in negotiations and interactions concerning commitments to other partners. In general, they follow acceptable moral

and ethical principles that lead to dependability and reliability. Some scholars have referred to organizational integrity as contractual trust (Langfield-Smith and Smith 2003, Sako 1992, van der Meer-Kooistra and Vosselman 2000). Ertel (2004) observed that contract negotiators should look beyond the signing of the contract and be implementation-minded negotiators rather than deal-minded negotiators. Rosetti and Choi (2005) report that opportunism was a problem in long-term strategic sourcing in the aerospace industry. After mutually dependent relationships were established, clients began to strangle suppliers with relentlessly short-term, cost-driven decisions.

Benevolence is the willingness to be receptive to the other party's concerns and making good-faith efforts to resolve them. Benevolence implies goodwill toward outsourcing partners and going beyond the profit motive. Benevolent firms proactively make good-faith efforts to resolve partner's concerns. Benevolence includes being helpful when not directly rewarded for being helpful. Anticipating your partner's needs may indicate a helpful attitude. But benevolence does not have to mean charity. Webb and Laborde (2005) pointed out to readers of this journal the importance of benevolence to the client. They observed that whether or not the vendor is taking care of the client will decide whether or not the outsourcing relationship continues. Langfield-Smith and Smith found that when difficulties in task programmability and output measurability precluded formal control using markets or hierarchical control, that trust, especially benevolence, played a role in control and allowed a relationship where there was high asset specificity and hence high interdependencies and a high risk of opportunism.

Ability refers to the skills, competencies, and knowledge that are relevant to the outsourcing commitments. Ability concerns proficiency (skills and competencies) in a specific context. 'Expertise' is a term used to describe this element of trust. When the relationship involves sourcing/outsourcing a process or a non-standardized product, the area of expertise may

be very narrow. Many outsourcing relationships are motivated by an organization's need to acquire in-depth skills and knowledge in a cost-beneficial manner. Insinga and Werle (2000) pointed out that ability is one of the two criteria that they use to determine if a process should be outsourced (potential for competitive advantage is the other).

Bhattacharjee (2002) points out that ability is both the competence to perform the intended behavior and the access to information required to perform the behavior appropriately. Feeny, Lacity and Willcocks (2005) identify three vendor capabilities that should be measured, that are, in fact, aspects of trust: delivery competency, relationship competency and transformation competency.

As shown, trusted systems, trusted institutions, and trusted partners all contribute the success of a BPO relationship. The appropriate deployment of these types of trust at various stages of the BPO transactional relationship is necessary.

STAGES OF THE TRANSACTION AND TRUST

According to TCE, transactional relationships have three stages: contact, contract and control (Carmel and Nicholson 2005, Nooteboom 1992, 1993). During the contact phase clients incur search costs and vendors incur marketing costs. Contract costs include identifying possible future contingencies, negotiation, design of safeguards, and investment in assets specific to the transactional relationship. Control costs include the costs of monitoring, settling disputes, renegotiation, and potential loss of investment due to the relationship breaking up. The type of trust needed to increase the probability of success is different during the different stages of a BPO relationship.

Contact Stage

The contact phase begins with the decision to purchase goods or services from a third party. When first initiating this decision-making process, if potential partners are unknown, organizations look to third parties. Trusted institutions are necessary for organizations to initiate this decision-making process. Without these trusted institutions, it would be too risky to even consider process outsourcing; organizations would keep the transaction within the hierarchy.

Organizations also look to others to identify the reputation of potential partners. This is analogous to Hung, Dennis and Robert's (2004) model of trust in virtual teams, which identified three important external cues (personal endorsements from known third parties, role-based information, and rule-based factors) as determinants of initial trust. In BPO, van der Meer-Kooistra and Vosselman (2000) identify the trust needed during this phase as stemming either from friendship and former contractual relationships or from reputation.

Carmel and Nicholson (2005) found that for small firms using offshore software outsourcing, the contact costs were lower than expected, due to the availability of the internet and online marketplaces. But Nicholson et al. (2006), when examining the outsourcing of the accounting and finance function to vendors in India, found that because of the absence of information on which to evaluate and benchmark vendors was a problem. Clients resorted to known intermediaries and consultants to intervene and "marriage broker" the initial phase of the relationship. This again indicates that known third parties are a substitute for trusted partners.

Contract Stage

The contract (service level agreement) describes the management control structure and process: each party's authority and responsibilities, the gathering and supplying of information,

evaluation of activities, payment structure, etc. In order to write the contract, trusted systems must exist. And the characteristics of the transaction determine the difficulty in identifying the aspects of the agreement.

Bartélemy (2003) pointed out that writing a poor contract is one of the ‘seven deadly sins’ of outsourcing and that good contracts have four characteristics: precise, complete, balanced and flexible. Khalfan (2003) presented a case study in this journal that pointed out that the critical and fundamental elements missing in the contract led to the demise of the BPO project. The contract influences how the parties will interact and cooperate in the control phase. As noted earlier, Ertel (2004) demonstrated the importance of integrity and benevolence by recommending that contract negotiators focus on the control phase during negotiations rather than trying to make the ‘best’ deal.

Control Stage

In this phase the transactions/activities take place and the parties control whether the activities and output are in accordance with the contractual rules. While trusted institutions are important if there are violations of the contract, if there are no violations, trusted partners are the most important. van der Meer-Kooistra and Vosselman (2000) note that the parties also have to react to changes in circumstances and activities may need to be changed. Because of this Bartélemy (2003) pointed out that another one of the seven deadly sins of outsourcing is overlooking personnel issues and that good communication and ethical behavior towards employees (integrity and benevolence) can help avoid problems. Langfield-Smith and Smith (2003) found that benevolent trust helped establish control when tightly specified rules could not be established and got even stronger in the face of more rigid performance expectations.

Thus, trusted institutions are the most important at the contact stage when parties do not know each other. Organizations need to know that institutional mechanisms exist in the environment to support their outsourcing efforts. Trusted systems are the most important during the contract stage when the characteristics of the transaction are determinants of the aspects of the contract. And trusted partners are the most important during the control stage, which is where most of the interactions take place.

CONCLUSIONS

Grover (2003) observed in this journal that a major challenge in BPM is interorganizational processes. He notes that companies will have to tear down their boundaries and open up all but the most proprietary of processes. He is, in essence, recognizing that most organizations will become extended enterprises. Here we have presented a framework that includes the role of trust in interfirm governance issues that arise in business process outsourcing.

We have used TCE and the IS conceptualizations of trust to offer clients and vendors a framework for identifying the issues involved in BPO. Because humans are characterized by bounded rationality and opportunism, transactions require specific investments /arrangements to safeguard long-term outsourcing relations, especially when the environment is uncertain – changes in technology, new or renewed products or tough competition. Asset specificity also matters in BPO, because depending on the specific type, different measures can be taken to mitigate opportunistic behavior of the other party.

We have also used the results of research in TCE and information systems to offer guidance for how to proceed through the stages of BPO, contact, contract and control. Trust is a

critical success factor in BPO. It is also complex and, as discussed in the framework, multiple types of trust need to be considered. This framework can be utilized in practice to aid clients and vendors in building and sustaining trust. It can be utilized by scholars to design relevant research projects.

FUTURE RESEARCH

As BPO becomes even more prevalent, the importance of research findings in this area will increase. One weakness of TCE involves how BPO and the related governance structure fit into an organization's strategy, culture and history. van der Meer-Kooistra and Vosselman (2000) found that institutional, strategic, cultural and historical factors are important for control structures. How these factors influence trust in BPO and/or how BPO influences these factors are important theoretical and empirical issues.

Another issue that arises in some BPO settings is the relative power of the client and the vendor. In areas closely related to BPO, such as supply chain management and customer relationship management, power has been identified as a relevant issue. Vangen and Huxham (2003) suggest that power is closely related to trust and control. How asymmetric power impacts opportunism, the related trust in other parties and the content of the contract is another important research question.

Finally, research that integrates the three types of trust, trusted systems, trusted institutions, and trusted partners, needs to be carried out in BPO settings. At this point in time, three separate streams of IS research exist. Identifying the interactions and interrelationships among the types of trust in BPO settings would surely prove insightful.

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Figure 1
Framework for the Role of Trust in Business Process Outsourcing



